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C O N F I D E N T I A L SECTION 01 OF 02 BAKU 000219

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SUBJECT: AZERBAIJAN: IMF READOUT ON ECONOMY IN LATE 2005
AND EARLY 2006

REF: BAKU 205

Classified By: Ambassador Reno L. Harnish III, Reasons 1.4 (b)(d).

11. (SBU) SUMMARY: According to the IMF resident representative, the slowdown in inflation during the last quarter of 2005 was due primarily to a combination of nominal appreciation in the manat and a deceleration in money growth.

In addition, it appears that many businesses did not raise prices in late 2005, following through on a Presidential Decree of May 2005 ordering a delay in price increases. The Consumer Price Index in January 2006, however, increased 1.3 percent, indicating that prices have started to rise. The IMF noted that the GOAJ had still not yet prepared a list of capital expenditure projects, although a mysterious government decree has allowed spending on a select number of projects to begin. The IMF warned that GOAJ spending plans for 2006 were a direct threat to the competitiveness of the non-oil sector and could lead to currency appreciation. END SUMMARY.

12. (SBU) At the February 2 meeting of the Revenue Management Group, the IMF reported that recent monetary data, which showed a sharp slowdown in the rate of growth of the broad money supply, confirmed that the slowdown in inflation in the last months of 2005 was related to a combination of nominal appreciation in the manat and a deceleration in money growth.

The IMF noted that these factors may have been associated with political uncertainties connected with the November parliamentary elections and the expectation among some members of the public that the manat would depreciate to 5,000 to the U.S. dollar on January 1 following the redenomination. There was also the likelihood that President Aliyev's May 2005 instruction to monopolists to delay price increases may have carried over through the pre-election period. The Consumer Price Index in January 2006, however, increased 1.3 percent, indicating that prices have started to rise.

13. (C) On the fiscal front, the IMF reported that the capital budget for 2006 had not yet been established and discussions continue between the Cabinet of Ministers and the President's office. The approved amount of possible capital expenditures could total close to USD 1 billion. A contact at the National Bank told EconOff that this "free" money represented a serious threat to the balance of the economy. The IMF also noted that a mysterious decree had been issued by the Cabinet of Ministers in mid-January that allowed spending on selected projects to commence. The IMF and Embassy have not been able to locate this decree and a contact at the National Bank told EconOff that he had not heard of the decree.

14. (C) The IMF resident representative commented that Fitch's

recent long-term rating report on Azerbaijan (which confirmed the BB (stable) sovereign rating) must have come as something of a disappointment to the GOAJ as it had been expecting an upgrade, as evidenced by GOAJ interest in a Euro-bond issue later this year and the rapid build-up of foreign assets by the State Oil Fund (SOFAZ) and the National Bank. There are rumors that Moody's is planning to come to Azerbaijan shortly to perform a sovereign debt rating. In previous discussions, Minister of Economic Development Babayev had told Ambassador Harnish that the GOAJ wanted to receive an "investment grade" sovereign debt rating in order to attract more international capital.

15. (SBU) The IMF representative also discussed the potential for manat appreciation and the impact on the competitiveness of the non-oil sector. He indicated that the spending plans of the GOAJ were a clear threat to the competitiveness of the non-oil sector and could lead to excess demand which would appreciate the real effective exchange rate. This real appreciation would put pressure on both the nominal exchange rate and on prices. The split between the two would depend on the National Bank policies - but in either case the competitiveness of the non-oil sector would be undermined. Experience suggested that the nominal appreciation of the manat is limited by political factors to about 10 percent per year and that remaining demand pressures would spill over into inflation.

16. (SBU) The IMF will send a technical assistance mission to Baku in late-February to review the appropriateness of the mid-2005 change in CPI methodology. There are suspicions that this change may have resulted in a systematic downward bias in the headline inflation numbers. This visit this will be followed by an Area Department mission in mid-April. At

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that time there may be a better indication of the GOAJ,s intentions for a possible precautionary stand-by arrangement.
HARNISH